TAXATION OF PUBLIC UTILITIES

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An intelligent discussion of this subject requires a preliminary analysis of the nature of public utilities and their relations to governmental bodies. If a public utility is to be regarded as a private enterprise, operated primarily for profit, subject to the ordinary restrictions imposed upon other profit-seeking enterprises, no objection can be raised to the levying of taxes upon its property or earnings in the same way that similar taxes are to be levied on the property or earnings of other private undertakings. On the other hand, if public utilities are to be regarded as agencies of the state or the municipality, performing strictly public services under stringent public regulation, the levying of taxes upon their property or earnings is quite another matter. At this moment the relations between public utilities and governmental bodies are in a transition stage, and, therefore, it is not easy to formulate a rule in regard to the taxation of utilities that will be universally recognized as correct in theory or practice. In my judgment, however, we can assume that the patent and inevitable tendency in the development of the relations between the utilities and the public is toward the recognition and full establishment of the agency theory.

Formerly, public utility investments were both in theory and in practice largely speculative, and the utilities were regulated very little. With the rapid growth of the cities and the disproportionate increase in the importance of public utilities, there has come a pretty general recognition of the fact that whatever may have been the nature of such utilities when they were first initiated, they have now become predominantly and essentially public. This country had come to a pass where thoughtful men recognized that the only alternative open for the future was public ownership or strict public regulation. The public service commission movement, which has been sweeping over the country during the past seven or eight years, has gone far toward establishing in the law and practice of the land the fact that these utilities, even where owned and operated by private

individuals or corporations, are public agencies performing public functions.

It would be inaccurate to say that the principle of public agency has yet been completely established or even universally recognized as proper. For example, the courts have held that public service corporations are entitled to earn a reasonable return upon the present fair value of their property, including in such value the present value of their land holdings, irrespective of the original cost of such lands. This rule has been somewhat restricted in certain recent cases, and the cost-of-reproduction theory, which for a number of years received widespread recognition in connection with the valuation of public utility properties for ratemaking, has recently been subjected to severe criticism by various courts and commissions. The reproduction-cost theory and the present-value-of-land theory are inconsistent with the public agency theory and in so far as they *continue* to hold their place in the practice of the country, this fact must be taken into consideration in the discussion of the taxation of public utilities.

Assuming that the public agency theory is bound to prevail in the long run, we are thrown back upon a consideration of the propriety of exploiting publicly owned utilities for the relief of taxation. For the principles governing the operation of privately owned utilities subject to stringent public regulation, so far as they relate to the burdens imposed upon the consumers for the benefit of the tax-paying public, should not differ from the principles applying to the operation of publicly owned utilities.

So long as public utilities were luxuries for the use and advantage of a small minority of the people, it could be urged with at least a show of reason that such utilities ought to pay not only ordinary taxes upon their tangible property but also special taxes or compensation for their special privileges in public rights of way. Certainly, it would seem unreasonable that a service designed for the use and profit of a small minority of the people should be given special privileges for the use of public property, to the manifest inconvenience and disadvantage of the great majority of the citizens of a city.

At the present time, however, the standard utilities, such as local transit, water supply, gas, electricity for light, heat and power, the telephone, and transportation terminals, have come to be necessities in the common life of the general public. They are no longer

mere luxuries. Moreover, they are not only necessary to the great majority of the individual citizens, but their proper development now has a fundamental and far-reaching influence upon the organic development of each urban community as a whole. The public nature of these services rests both upon their universality and upon their community influence. Under these conditions it seems hardly necessary to argue that the governmental bodies should not seek to make profits out of such enterprises for the relief of general taxation. To do so would be to tax public property and public agencies.

Even if we assume the ultimate establishment of the public agency theory in universal practice, we shall still have to consider just what that means. When we escape from the theory that public utilities are luxuries operated for profit, we start off on a long road with many possible stopping places. Many public services are even now rendered free to those who have need of them. While it is a rather far cry from the assertion that public utilities should not be operated for profit to the prophecy that some time they will be operated entirely at the expense of the general taxpayers, the road from one point to the other in public policy is a direct one. At the present time, it is customary to say that public utilities ought not to be operated for profit, but that they should be treated as self-sustaining business enterprises rendering their services at cost. Yet, in practice, while the rearguard of the utilities lingers in the realm of profitable exploitation, the vanguard has reached beyond the neutral area into the field of governmental subsidy. Indeed, it requires careful analysis to determine just what it takes to make a utility fully self-sustaining. For example, while the writer has strongly opposed any system of profit-making or special taxation that would result in taking a portion of the earnings of the utility out of the business, he has with equal urgency favored a plan by which public utilities should be made to pay for themselves out of earnings. In other words, according to his definition, a public utility is fully self-sustaining only in case its earnings are sufficient to pay operating expenses, interest on investment and also amortization charges. This definition has a leaning toward conservatism. It is based upon the theory that the capital invested in a public utility should be retired within a reasonable time, partly because the physical property may become obsolete and partly because a utility that has paid for itself will be in a better position to render increased service at reduced

cost, in accordance with the inevitable trend of public need as time goes on.

It is possible, however, to regard a utility as self-sustaining where it merely pays the expenses of operation plus depreciation and interest charges, leaving the capital itself either to be regarded as a permanent investment or to be amortized out of the proceeds of taxation. So long as utilities are owned and operated by private corporations subject to commission regulation, the tendency seems to be to regard the investment as a permanent one and therefore to make no provision in the rates for amortization. Under public ownership, on the other hand, no clear tendency can be traced. In some cases both interest and sinking fund on public utility debts are taken care of out of taxes as a general offset for the direct services rendered by the utility to other departments of the government. Sometimes utility bonds are retired out of earnings, and in some cases even the extensions of the plant itself are made at the expense of the consumers. The rule is, however, that publicly owned utilities do not pay taxes on their property or earnings in the same way that privately owned utilities do. At the present time there is a tendency to require publicly owned utilities to render a strict account of themselves, including an estimate of the amount of taxes which they would have to pay if they were in private hands. This is merely for the purposes of comparison and public information.

We may mark several stages in public utility development as follows:

1. Public utilities operated for profit and, in case of private ownership, accompanied by various forms of taxation and partnership intended to give the public a share in the profits.

2. Public utilities operated at cost, including in cost ordinary taxes and interest, and amortization charges sufficient to retire the investment within a reasonable fixed period.

3. Public utilities operated at cost, including in cost ordinary taxes and interest charges, but no amortization.

4. Public utilities operated at cost, including in cost interest charges, but excluding both amortization charges and general taxes.

5. Public utilities operated at cost, with the help of subsidies from taxation to take care of interest charges.

6. Public utilities operated according to a fixed standard of rates and service, with deficits in operating expenses made up out of taxation.

7. Public utilities operated at the expense of the taxpayers, all service being rendered free of charge.

The public agency theory is controlling in all of the stages just enumerated except the first. This first stage may be regarded as a "left over." It is a relic of the past. At the same time, some individual utilities are so surrounded by tradition and so fortified by contracts and judicial decisions that no one can foresee how long they may linger in this first stage. So far and so long as public utilities continue to be operated on a speculative basis in accordance with the ancient traditions, taxation may be regarded as a legitimate means of securing public revenue and also as an instrument for shrinking the values of special privileges that have slipped out of public control in past years through the improvidence or corruption of public officials. Taxation should certainly be regarded as one of the most effective weapons the state has for subduing the pride and independence of the perpetual franchise barons. Relief from various forms of taxation may be used properly and effectively as a means of inducing public utility franchise holders to accept a readjustment of their contractual rights with the public, wherever such a readjustment seems to be of vital public necessity. Moreover, any income which the public may derive from special forms of taxation of privately owned public utilities ought, in all good conscience, to be put away into a "war-chest" to help in the inevitable campaign for the conquest of the refractory utility corporations. By "conquest" I mean acquisition, and by "campaign" I mean the process of acquisition at a reasonable price.

Of primary interest in the discussion of the taxation of public utilities is the question as to whether or not taxes should be levied on land devoted to public use in connection with the supply of a utility. One of the chief points at which the agency theory has been limited by the trend of court decisions is in the matter of the value of land upon which public service corporations are entitled to a fair return. As the law now stands, the private owners of a public utility are entitled to the benefit of the increment in land values. One of the tax reform programs that is receiving wide support calls for the gradual increase of the tax on land values and the gradual elimination of other taxes. This policy, if carried through to the final limit, would have the effect of taking away all or most of the selling value of land, and would therefore deprive public utility owners, by means of taxation, of the increment in land value in just the same way as it would

deprive other land owners of such increment. If the gradual stiffening of the land tax is to be adopted as a permanent public policy, there certainly is no reason why the private owners of public utilities should be exempted from its effects. Therefore, it becomes important to consider just what is the effect of the taxation of land devoted to public use in connection with a public utility. Under monopoly conditions, if the rate charged for the service is a fixed sum, such as the five-cent street car fare, it is obvious that the exemption of public utility land from taxation would redound to the benefit of the owners of the public utility and not to its patrons. If, instead of a predetermined, fixed rate for the service, a corporation is permitted to charge "all the traffic will bear," then, also, the exemption of the company's land from taxation would result in a direct benefit to the owners rather than to the patrons of the utility. If, however, the utility is subject to continuing regulation, on the theory that it will be allowed to earn a fair return upon a fair present value of the property and no more, then the exemption from taxation of land occupied by the utility would result in a reduction of rates or an improvement of service and in either case would redound to the benefit of the utility's patrons, and would not confer any particular advantage upon the owners of the utility. This result follows from the fact that under the system of continuous regulation all taxes are made a part of operating expenses. Therefore, it would appear that in so far as public utilities are to be subject to constant and effective regulation in the matter of rates and charges, the correct policy would be to exempt their lands from taxation, on the same theory that any other lands devoted to public use are so exempted. The fact that the owners of the utilities are considered to be entitled to the increment in land values has no bearing upon the subject, for the taxation or exemption of the particular lands owned by the public utilities would under conditions of perfect regulation be a matter of interest to the consumers on the one hand and the general taxpayers on the other, but not to the owners of the utility as such.

What has just been said in regard to the land tax applies with equal force to the special franchise or easement tax so far as this tax applies to intangibles. The special franchise tax of New York, however, defines the intangible right to use the street as land, and the tracks, poles, wires, pipes and other fixtures in the street as improvements upon land, analogous to the buildings on land not situated

within street limits. The taxation of buildings and street fixtures devoted to public use by a public utility has all of the disadvantages of the taxation of improvements generally, except that in cases where the utility is not subject to continuous public regulation as to rates the taxation of these portions of the company's property cannot be shifted to the shoulders of the consumers. It would seem, therefore, that the special franchise tax, as applied either to intangibles or to tangibles, is of no value as a restrictive measure except in the case of public utilities which are not subject to public regulation or which have their rates established by contract. Under all other circumstances, the tax upon public utility real estate, whether in the streets or not, is to be considered merely as a revenue measure. If the occupation of land and the use of buildings and other improvements upon land are considered as a part of the legitimate cost of a self-sustaining business, then public utilities may be required to contribute their share to the public treasury to the same extent that other occupiers of land and buildings are required to contribute. Exemption from ordinary real estate taxes will gradually be brought about as public utility services come to be recognized as more and more public in character.

The personal property tax, the corporate franchise tax, and the tax on gross or net earnings, as applied to public utilities, are to be regarded as relics of the time when public service corporations, in spite of their name, were not regarded as agencies performing public functions. These kinds of taxes cannot be justified except as they apply to public utilities still lingering in the speculative profit-seeking stage. To the extent that privately owned utilities are brought under effective public regulation, these taxes become as illogical as they would be if applied to municipal water works, docks, markets and lighting plants.

We must now consider that group of taxes and service charges which in reality represent legitimate items of operating cost. This group includes the obligation to pave and repair streets (or in lieu thereof the paving commutation tax), sprinkling and snow removal charges, license fees, pole taxes, bridge tolls, and so forth. The theory of these taxes and charges is either that the public utility has the special use of certain public property to the disadvantage of other users and should therefore be required to pay an equalizing tax or rental, or that in the course of its operations a public utility actually

destroys portions of the street which t ought to replace, or compels the general municipal authorities to incur expenses which the utility ought to stand. In so far as it can be shown that the presence of street railway tracks in a street destroys the pavement or requires the widening of the roadway for the accommodation of general traffic, the additional costs involved may properly be charged to the street railway if that utility is to be self-sustaining. In like manner, as the operation of cars increases the dust nuisance, a part of the cost of oiling or sprinkling the streets may properly be charged to the street railway. The same reasoning applies to the removal of snow and ice. Furthermore, in all cases, the street railway or other utility should be charged with the actual damages to persons or property caused by the construction or operation of the utility in the streets. The erection of poles and wires naturally interferes with and damages to a certain extent the shade trees along the streets, and the laying of conduits or water or gas pipes may also damage trees and injure pavements. Whether these various extra expenses and costs shall be paid directly by the utility, or whether they shall be paid in the form of commutation taxes, is immaterial to this discussion. In either case, they form a legitimate part of the operating expenses and cost of service of the utility. What forms they shall take is a question of public expediency and public policy in each state or city.

Finally, we should consider those forms of forced contributions which, though matters of contract, are nevertheless for all practical purposes in the nature of a tax imposed upon public utility corporations as the price of their franchise. They include various forms of free services and division of profits. Where a city enters into a co-partnership scheme with a private corporation, with a provision that the city shall have a certain share of the net earnings of the enterprise, it is to be noted that there is a tendency for the city to abandon the public agency theory and to ally itself with the private corporation as a profit seeker. In so far as profit sharing and other forms of contractual payments are adopted as the most expedient means under the particular circumstances for securing to the city a fund to be used in the purchase of the utility plant, such modes of securing money from public utilities seem to be entirely justified and not fundamentally inconsistent with the public agency theory.

In concluding the discussion of this complex and somewhat elusive subject, we should reëmphasize the following principles:

1. In so far as public utilities remain on a speculative basis, and continue in the enjoyment of special privileges protected by judicial decisions and contractual rights, taxation may be resorted to both as a revenue measure and as a weapon for regaining public control over such utilities.

2. In so far as privately owned public utilities are subject to adequate continuous public regulation as to service and rates, the principles of taxation as applied to them should be the same as the principles of taxation and profitmaking applied to publicly owned utilities.

3. Whatever revenue public bodies may derive from public utility taxes or contributions, except to the extent that such taxes and contributions may be regarded as a part of the actual and legitimate cost of service, should be used as a fund for amortizing, first, franchise and other intangible values and, second, the capital investment in the physical property of the utilities.

4. As the public agency theory of public utility operation comes to be more widely recognized and more fully established, the tendency will undoubtedly be to diminish and finally eliminate public utility taxes and contributions and, *per contra*, to subsidize public utilities out of taxation to the end that a higher standard of service may be rendered at a fixed or diminishing charge to the public.